FX Daily: 50bp hikes are the policy path of 'least regret'

The Reserve Bank of New Zealand (RBNZ) has today surprised with a 50bp hike, calling this a policy path of 'least regret'. Canada may well follow suit with a 50bp hike later today as an increasing number of central banks refuse to take risks with rising inflation expectations. The Fed should be firmly in this camp too, keeping the dollar bid on dips

Adrian Orr, governor of New Zealand's Reserve Bank

USD: Can we learn any FX lessons from RBNZ?

The title to RBNZ's policy release said it all: 'Monetary tightening brought forward'. This was the type of front-loaded tightening that had been seen in the central banks of Brazil, Russia and the Czech Republic last year and is now making its way into the developed market space. The 50bp hike in rates to 1.50% was justified as a move to address the increasing risk of high inflation expectations from both externally and importantly internally-generated inflation. Pitching the 'stitch in time saves nine' saying – i.e. fix the problem now before it becomes bigger – RBNZ implied that larger rate hikes now could alleviate the need for some disorderly adjustments later.

Local commentators read today's move as a 'dovish 50bp hike' and after briefly rallying, the New Zealand Dollar (NZD) is now down 0.4% on the day. Equally, bond yields are 10-15bp lower across the curve as investors have taken the move as a signal that the terminal rate might be a little lower if RBNZ hikes early and aggressively

Can we take any lessons here for Fed policy and its implications for the dollar? We suspect that part of the sell-off in the NZD is down to positioning and aggressive tightening expectations which had seen the RBNZ policy rate close to 4% over the next two years. In fact, having been a central bank that had briefed against NZD strength for so long, the RBNZ today welcomed currency strength in fighting imported inflation. Should we conclude today that front-loaded tightening is bearish for a currency? We would say 'no'.

Front-loaded tightening should lead to flat or inverted yield curves, which in our experience are positive for currencies. One extreme example, which some customers have been asking us about, is the extreme US yield curve inversion in the early 1980s when new Federal Reserve Chair Paul Volcker took rates to 15% and sent the US economy into recession. The dollar soared during this period. Inverted yield curves also discourage FX hedging of bond portfolio flows – i.e. is positive for a currency.

In short, we are not fans of concluding that, from today's RBNZ experience, the dollar is near a top and will sell off when the Fed brings its own monetary tightening forward when it hikes rates 50bp on 4 May.

For today, the US data calendar is quiet apart from the March PPI figure. The dollar yesterday was a little weaker on some softness in core US CPI. Yet as James Knightley concludes, it will be a slow descent for inflation and should not prevent the Fed from taking the funds rate to 3% early next year. DXY is to consolidate above 100 and could enjoy some gains if USD/JPY can make it above a big technical level at 125.85.

EUR: Holding steady above 1.0800

Were it not for some more bearish headlines emerging out of Ukraine yesterday afternoon, EUR/USD would probably be trading closer to 1.09 now. As it is, expectations of increased hostility in Eastern Ukraine, more sanctions against Russia, and higher energy prices are all keeping the euro on the back foot. We doubt investors are yet ready to push EUR/$ below 1.0800 so shortly ahead of tomorrow's ECB meeting. Please see our scenario analysis for tomorrow's meeting here. But, as above, we feel that front-loaded Fed tightening is a dollar positive (we have the Fed hiking 50bp in May, June and July) meaning that EUR/USD could well be approaching 1.05 this summer.

GBP: Upside surprise in March CPI to keep GBP supported

Today's broad-based upside surprise in March UK CPI looks set to keep aggressive Bank of England tightening expectations in place for a little longer and keep GBP supported. It was interesting today to see that despite a sharp drop in consumer confidence, the RBNZ did hike 50bp – citing inflation as one of the reasons that consumer confidence was falling. Avoiding tightening because of weak consumer confidence could therefore be counter-productive.

Today's UK inflation data suggests CPI could be peaking in the 8.5% area in April and could bring back expectations that the BoE hikes by 50bp in May – currently a 28bp hike is priced. That can see EUR/GBP continuing to press the 0.8300 area, while GBP/JPY can push onto the 167.50 area.

CAD: 50bp from Bank of Canada today

Strong growth, tight labour markets, and above-target inflation should see the [Bank of Canada (BoC) hike 50bp today to 1.00%](). The focus will also be on what BoC does with its balance sheet, where it could potentially announce some fast quantitative tightening (QT). Given the short duration of its bond portfolio, any end of reinvesting maturing bonds could see the BoC balance sheet shrink quickly over the next couple of years.

All of the above looks priced in, however, where money markets also price the policy rate (now 0.50%) at 2.60% by year-end. Does front-loaded tightening from the BoC mean that the CAD, like the NZD, has to sell off? Not necessarily, USD/CAD has already retraced 50% of the March drop to 1.2400, and even if we were to see a temporary spike in USD/CAD to the 1.2700 area, we suspect plenty of CAD buyers would return. Healthy terms of trade gains on the back of the commodity shock leave the CAD as one of our preferred currencies this year – expecting levels in the 1.20-1.23 area as the year progresses.

Authors

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com